

### Attachment 3

## PCAOB's Description of the Development Process for Auditing Standard No. 3

PCAOB Release No. 2004-006, June 9, 2004, pages 1-3

The Board commenced a standards-development project on audit documentation by convening a public roundtable discussion on September 29, 2003, to discuss issues and hear views on audit documentation. Before that roundtable discussion, the Board prepared and released a briefing paper on audit documentation, which posed several questions to help identify the objectives – and the appropriate scope and form – of audit documentation. In addition, the Board asked participants to address specific practice issues relating to, among other things, changes in audit documentation after an audit report has been released; the essential elements and the appropriate amount of detail of audit documentation; the effect on audit documentation of a principal auditor's decision to use the work of other auditors; and retention of audit documentation.

Taking into consideration comments from participants in this roundtable discussion, advice from the Board's staff, and other input, the Board determined that the existing interim auditing standard on audit documentation was not sufficient in providing direction to ensure that auditors appropriately document both the work they perform and the conclusions they reach in connection with audits and other engagements. On November 21, 2003, the Board issued a proposed auditing standard entitled *Audit Documentation*, as well as a related amendment to an interim auditing standard (paragraph .12 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*).

The Board received 38 comment letters from a variety of interested parties, including auditors, regulators, professional associations, and government agencies. Those comments led to some changes in the requirements of the standard.

The Board's standard on audit documentation will be one of the fundamental building blocks on which both the integrity of audits and the Board's oversight will rest. The integrity of an audit depends, in large part, on the existence of a complete and understandable record of the work that the auditor performed, the evidence gathered, and the conclusions reached. Meaningful review by managers and partners, or by the Board in the context of its inspections, would be difficult, if not impossible, without adequate documentation. Clear and comprehensive audit documentation is essential for auditors to enhance the quality of the audit and for the Board to fulfill its mandate to inspect registered public accounting firms "to assess the degree of compliance" of those firms with applicable standards and laws.

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**Sections 68.2 – 68.5 of the  
California Board of Accountancy Regulations  
(Title 16 of The California Code of Regulations)  
Related to Audit Documentation**

**68.2 Identification of Audit Documentation.**

(a) To provide for the identification of audit documentation, audit documentation shall include an index or guide to the audit documentation which identifies the components of the audit documentation.

(b) In addition to the requirements of Business and Professions Code Section 5097(b), audit documentation shall provide the date the document or working paper was completed by the preparer(s) and any reviewer(s), and shall include the identity of the preparer(s) and any reviewer(s).

(c) Audit documentation shall include both the report date and the date of issuance of the report.

NOTE: Authority cited: Section 5010, 5018, and 5098, Business and Professions Code.  
Reference: Sections 5097 and 5098, Business and Professions Code.

**68.3 Retention Period for Audit Documentation.**

(a) The retention period mandated by Business and Professions Code Section 5097 shall be measured from the report date.

(b) If audit documentation is required to be kept for longer than seven years because of a pending Board investigation or disciplinary action, audit documentation shall not be destroyed until the licensee has been notified in writing by the Board of the closure of a Board investigation or disciplinary proceeding.

(c) Any documents required to be maintained by Business and Professions Code Section 5097 or these regulations shall be maintained in accessible form.

(d) Audit documentation shall be retained whether or not the documentation supports the auditor's final conclusions. All audit documentation regarding any significant matter related to the audit shall be retained whether or not the documentation contains information or data inconsistent with the auditor's final conclusions. Significance of a matter shall be determined based on an objective analysis of the facts and circumstances. Audit documentation to be retained shall also include all documentation of consultations on, or resolutions of, any differences of opinion regarding the exercise of professional judgment.

NOTE: Authority cited: Section 5010, 5018, and 5098, Business and Professions Code. Reference: Sections 5097 and 5098, Business and Professions Code.

#### **68.4. Changes in Audit Documentation After Issuance of the Report.**

(a) Changes in audit documentation include any addition, removal, deletion, substitution, or editing of audit documentation, including, but not limited to, physical or electronic additions to any audit documentation file or preexisting audit documentation, occurring after the date of issuance of the audit report which is supported in whole or in part by the audit documentation.

(b) Except as provided in subsection (c), in addition to any other documentation required by professional standards, any changes in audit documentation shall provide the identity of the person(s) making the change, and identity of any person(s) approving the change, the date of the change, and the reason for the change if the reason is other than the assembling of pre-existing documents. The documentation which is changed shall contain sufficient detail to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, reason for, and extent of the change.

(c) During a 60-day period after the date of issuance of the audit report, documents may be added to the file for the assemblage and documentation of work previously performed. Nothing in this subsection authorizes the deferral of audit procedures required to be performed prior to the date of issuance of the report.

NOTE: Authority cited: Section 5010, 5018, and 5098, Business and Professions Code.  
Reference: Sections 5097 and 5098, Business and Professions Code.

#### **68.5. Audit Documentation Retention and Destruction Policy.**

(a) Licensees shall maintain, and document compliance with, a written Audit Documentation Retention and Destruction Policy which provides for the preservation of audit documentation for the full time period required by Business and Professions Code Section 5097. The policy and documentation of compliance shall be available to the Board upon request.

(b) This policy shall provide for the authorized custody, security, access, retention, and destruction of the documentation. This policy shall, at a minimum, include the following:

- (1) procedures for the maintenance of back-up copies of electronic audit documentation at secure locations,
- (2) procedures for maintaining audit documentation,
- (3) procedures for approving any changes to audit documentation,
- (4) procedures for approving the destruction of documentation when no longer required to be maintained by Business and Professions Code Section 5097.

(c) The procedure required by subsection (b)(4) shall provide for identifying the persons, by name or position, authorized to approve the destruction of audit documentation. In the alternative, the procedure required by subsection (b)(4) may be self-executing once the retention period has expired.

NOTE: Authority cited: Section 5010, 5018, and 5098, Business and Professions Code. Reference: Sections 5097 and 5098, Business and Professions Code.

**BUSINESS AND PROFESSIONS CODE SECTIONS 5097- 5098**

5097. (a) Audit documentation shall be a licensee's records of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in an audit engagement. Audit documentation shall include, but is not limited to, programs, analyses, memoranda, letters of confirmation and representation, copies or abstracts of company documents, and schedules or commentaries prepared or obtained by the licensee.

(b) Audit documentation shall contain sufficient documentation to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, extent, and results of the auditing or other procedures performed, evidence obtained, and conclusions reached, and to determine the identity of the persons who performed and reviewed the work.

(c) Failure of the audit documentation to document the procedures applied, tests performed, evidence obtained, and relevant conclusions reached in an engagement shall raise a presumption that the procedures were not applied, tests were not performed, information was not obtained, and relevant conclusions were not reached. This presumption shall be a rebuttable presumption affecting the burden of proof relative to those portions of the audit that are not documented as required in subdivision (b). The burden may be met by a preponderance of the evidence.

(d) Audit documentation shall be maintained by a licensee for the longer of the following:

- (1) The minimum period of retention provided in subdivision (e).
- (2) A period sufficient to satisfy professional standards and to comply with applicable laws and regulations.

(e) Audit documentation shall be maintained for a minimum of seven years which shall be extended during the pendency of any board investigation, disciplinary action, or legal action involving the licensee or the licensee's firm. The board may adopt regulations to establish a different retention period for specific categories of audit documentation where the board finds that the nature of the documentation warrants it.

(f) Licensees shall maintain a written documentation retention and destruction policy that shall set forth the licensee's practices and procedures complying with this article.

5098. The board may adopt regulations to implement, interpret, and make specific provisions relating to the following:

(a) Requirements for licensees maintaining an audit documentation retention policy and procedures for review and approval of audit documentation destruction.

(b) Procedures for the identification, dating, and retention of audit documentation.

AUDITING STANDARD No. 3 – Audit Documentation

June 9, 2004

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Auditing Standard No. 3 –

***Audit Documentation***

**PCAOB**

Public Company Accounting Oversight Board

[Effective pursuant to SEC Release No. 34-50253; File No. PCAOB-2004-05, August 25, 2004]

## Auditing and Related Professional Practice Standards

### Auditing Standard No. 3, *Audit Documentation* [supersedes SAS No. 96, *Audit Documentation*]

#### Introduction

1. This standard establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to the standards of the Public Company Accounting Oversight Board ("PCAOB"). Such engagements include an audit of financial statements, an audit of internal control over financial reporting, and a review of interim financial information. This standard does not replace specific documentation requirements of other standards of the PCAOB.

#### Objectives of Audit Documentation

2. *Audit documentation* is the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation also facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached by the auditor. Audit documentation also may be referred to as *work papers* or *working papers*.

Note: An auditor's representations to a company's board of directors or audit committee, stockholders, investors, or other interested parties are usually included in the auditor's report accompanying the financial statements of the company. The auditor also might make oral representations to the company or others, either on a voluntary basis or if necessary to comply with professional standards, including in connection with an engagement for which an auditor's report is not issued. For example, although an auditor might not issue a report in connection with an engagement to review interim financial information, he or she ordinarily would make oral representations about the results of the review.

3. Audit documentation is reviewed by members of the engagement team performing the work and might be reviewed by others. Reviewers might include, for example:

- a. Auditors who are new to an engagement and review the prior year's documentation to understand the work performed as an aid in planning and performing the current engagement.
- b. Supervisory personnel who review documentation prepared by assistants on the engagement.
- c. Engagement supervisors and engagement quality reviewers who review documentation to understand how the engagement team reached significant conclusions and whether there is adequate evidential support for those conclusions.
- d. A successor auditor who reviews a predecessor auditor's audit documentation.
- e. Internal and external inspection teams that review documentation to assess audit quality and compliance with auditing and related professional practice standards; applicable laws, rules, and regulations; and the auditor's own quality control policies.
- f. Others, including advisors engaged by the audit committee or representatives of a party to an acquisition.

#### **Audit Documentation Requirement**

4. The auditor must prepare audit documentation in connection with each engagement conducted pursuant to the standards of the PCAOB. Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation should be appropriately organized to provide a clear link to the significant findings or issues.<sup>1/</sup> Examples of audit documentation include memoranda, confirmations, correspondence, schedules, audit programs, and letters of representation. Audit documentation may be in the form of paper, electronic files, or other media.

5. Because audit documentation is the written record that provides the support for the representations in the auditor's report, it should:

- a. Demonstrate that the engagement complied with the standards of the PCAOB,

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<sup>1/</sup> See paragraph 12 of this standard for a description of significant findings or issues.

- b. Support the basis for the auditor's conclusions concerning every relevant financial statement assertion, and
- c. Demonstrate that the underlying accounting records agreed or reconciled with the financial statements.

6. The auditor must document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions.<sup>2/</sup> Audit documentation must clearly demonstrate that the work was in fact performed. This documentation requirement applies to the work of all those who participate in the engagement as well as to the work of specialists the auditor uses as evidential matter in evaluating relevant financial statement assertions. Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement:

- a. To understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and
- b. To determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review.

Note: An *experienced auditor* has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry.

7. In determining the nature and extent of the documentation for a financial statement assertion, the auditor should consider the following factors:

- Nature of the auditing procedure;
- Risk of material misstatement associated with the assertion;
- Extent of judgment required in performing the work and evaluating the results, for example, accounting estimates require greater judgment and commensurately more extensive documentation;
- Significance of the evidence obtained to the assertion being tested; and

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<sup>2/</sup> Relevant financial statement assertions are described in paragraphs 68-70 of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*.



- Responsibility to document a conclusion not readily determinable from the documentation of the procedures performed or evidence obtained.

Application of these factors determines whether the nature and extent of audit documentation is adequate.

8. In addition to the documentation necessary to support the auditor's final conclusions, audit documentation must include information the auditor has identified relating to significant findings or issues that is inconsistent with or contradicts the auditor's final conclusions. The relevant records to be retained include, but are not limited to, procedures performed in response to the information, and records documenting consultations on, or resolutions of, differences in professional judgment among members of the engagement team or between the engagement team and others consulted.

9. If, after the documentation completion date (defined in paragraph 15), the auditor becomes aware, as a result of a lack of documentation or otherwise, that audit procedures may not have been performed, evidence may not have been obtained, or appropriate conclusions may not have been reached, the auditor must determine, and if so demonstrate, that sufficient procedures were performed, sufficient evidence was obtained, and appropriate conclusions were reached with respect to the relevant financial statement assertions. To accomplish this, the auditor must have persuasive other evidence. Oral explanation alone does not constitute persuasive other evidence, but it may be used to clarify other written evidence.

- If the auditor determines and demonstrates that sufficient procedures were performed, sufficient evidence was obtained, and appropriate conclusions were reached, but that documentation thereof is not adequate, then the auditor should consider what additional documentation is needed. In preparing additional documentation, the auditor should refer to paragraph 16.
- If the auditor cannot determine or demonstrate that sufficient procedures were performed, sufficient evidence was obtained, or appropriate conclusions were reached, the auditor should comply with the provisions of AU sec. 390, *Consideration of Omitted Procedures After the Report Date*.

### Documentation of Specific Matters

10. Documentation of auditing procedures that involve the inspection of documents or confirmation, including tests of details, tests of operating effectiveness of controls, and walkthroughs, should include identification of the items inspected. Documentation

of auditing procedures related to the inspection of significant contracts or agreements should include abstracts or copies of the documents.

Note: The identification of the items inspected may be satisfied by indicating the source from which the items were selected and the specific selection criteria, for example:

- If an audit sample is selected from a population of documents, the documentation should include identifying characteristics (for example, the specific check numbers of the items included in the sample).
- If all items over a specific dollar amount are selected from a population of documents, the documentation need describe only the scope and the identification of the population (for example, all checks over \$10,000 from the October disbursements journal).
- If a systematic sample is selected from a population of documents, the documentation need only provide an identification of the source of the documents and an indication of the starting point and the sampling interval (for example, a systematic sample of sales invoices was selected from the sales journal for the period from October 1 to December 31, starting with invoice number 452 and selecting every 40<sup>th</sup> invoice).

11. Certain matters, such as auditor independence, staff training and proficiency and client acceptance and retention, may be documented in a central repository for the public accounting firm ("firm") or in the particular office participating in the engagement. If such matters are documented in a central repository, the audit documentation of the engagement should include a reference to the central repository. Documentation of matters specific to a particular engagement should be included in the audit documentation of the pertinent engagement.

12. The auditor must document significant findings or issues, actions taken to address them (including additional evidence obtained), and the basis for the conclusions reached in connection with each engagement. *Significant findings or issues* are substantive matters that are important to the procedures performed, evidence obtained, or conclusions reached, and include, but are not limited to, the following:

- a. Significant matters involving the selection, application, and consistency of accounting principles, including related disclosures. Significant matters include, but are not limited to, accounting for complex or unusual transactions, accounting estimates, and uncertainties as well as related management assumptions.

- b. Results of auditing procedures that indicate a need for significant modification of planned auditing procedures, the existence of material misstatements, omissions in the financial statements, the existence of significant deficiencies, or material weaknesses in internal control over financial reporting.
- c. Audit adjustments. For purposes of this standard, an *audit adjustment* is a correction of a misstatement of the financial statements that was or should have been proposed by the auditor, whether or not recorded by management, that could, either individually or when aggregated with other misstatements, have a material effect on the company's financial statements.
- d. Disagreements among members of the engagement team or with others consulted on the engagement about final conclusions reached on significant accounting or auditing matters.
- e. Circumstances that cause significant difficulty in applying auditing procedures.
- f. Significant changes in the assessed level of audit risk for particular audit areas and the auditor's response to those changes.
- g. Any matters that could result in modification of the auditor's report.

13. The auditor must identify all significant findings or issues in an *engagement completion document*. This document may include either all information necessary to understand the significant findings, issues or cross-references, as appropriate, to other available supporting audit documentation. This document, along with any documents cross-referenced, should collectively be as specific as necessary in the circumstances for a reviewer to gain a thorough understanding of the significant findings or issues.

Note: The engagement completion document prepared in connection with the annual audit should include documentation of significant findings or issues identified during the review of interim financial information.

#### **Retention of and Subsequent Changes to Audit Documentation**

14. The auditor must retain audit documentation for seven years from the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements (*report release date*), unless a longer period of time is required by law. If a report is not issued in connection with an engagement, then the audit documentation must be retained for seven years from the date that fieldwork was substantially completed. If the auditor was unable to complete the engagement, then

the audit documentation must be retained for seven years from the date the engagement ceased.

15. Prior to the report release date, the auditor must have completed all necessary auditing procedures and obtained sufficient evidence to support the representations in the auditor's report. A complete and final set of audit documentation should be assembled for retention as of a date not more than 45 days after the report release date (*documentation completion date*). If a report is not issued in connection with an engagement, then the documentation completion date should not be more than 45 days from the date that fieldwork was substantially completed. If the auditor was unable to complete the engagement, then the documentation completion date should not be more than 45 days from the date the engagement ceased.

16. Circumstances may require additions to audit documentation after the report release date. Audit documentation must not be deleted or discarded after the documentation completion date, however, information may be added. Any documentation added must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it.

17. Other standards require the auditor to perform procedures subsequent to the report release date in certain circumstances. For example, in accordance with AU sec. 711, *Filings Under Federal Securities Statutes*, auditors are required to perform certain procedures up to the effective date of a registration statement.<sup>3/</sup> The auditor must identify and document any additions to audit documentation as a result of these procedures consistent with the previous paragraph.

18. The office of the firm issuing the auditor's report is responsible for ensuring that all audit documentation sufficient to meet the requirements of paragraphs 4-13 of this standard is prepared and retained. Audit documentation supporting the work performed by other auditors (including auditors associated with other offices of the firm, affiliated firms, or non-affiliated firms), must be retained by or be accessible to the office issuing the auditor's report.<sup>4/</sup>

19. In addition, the office issuing the auditor's report must obtain, and review and retain, prior to the report release date, the following documentation related to the work

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<sup>3/</sup> Section 11 of the Securities Act of 1933 makes specific mention of the auditor's responsibility as an expert when the auditor's report is included in a registration statement under the 1933 Act.

<sup>4/</sup> Section 106(b) of the Sarbanes-Oxley Act of 2002 imposes certain requirements concerning production of the work papers of a foreign public accounting firm on whose opinion or services the auditor relies. Compliance with this standard does not substitute for compliance with Section 106(b) or any other applicable law.

performed by other auditors (including auditors associated with other offices of the firm, affiliated firms, or non-affiliated firms):

- a. An engagement completion document consistent with paragraphs 12 and 13.

Note: This engagement completion document should include all cross-referenced, supporting audit documentation.

- b. A list of significant fraud risk factors, the auditor's response, and the results of the auditor's related procedures.
- c. Sufficient information relating to any significant findings or issues that are inconsistent with or contradict the final conclusions, as described in paragraph 8.
- d. Any findings affecting the consolidating or combining of accounts in the consolidated financial statements.
- e. Sufficient information to enable the office issuing the auditor's report to agree or to reconcile the financial statement amounts audited by the other auditor to the information underlying the consolidated financial statements.
- f. A schedule of audit adjustments, including a description of the nature and cause of each misstatement.
- g. All significant deficiencies and material weaknesses in internal control over financial reporting, including a clear distinction between those two categories.
- h. Letters of representations from management.
- i. All matters to be communicated to the audit committee.

If the auditor decides to make reference in his or her report to the audit of the other auditor, however, the auditor issuing the report need not perform the procedures in this paragraph and, instead, should refer to AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

20. The auditor also might be required to maintain documentation in addition to that required by this standard.<sup>5/</sup>

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<sup>5/</sup> For example, the SEC requires auditors to retain, in addition to documentation required by this standard, memoranda, correspondence, communications (for example, electronic mail), other documents, and records (in the

### Effective Date

21. This standard is effective for audits of financial statements, which may include an audit of internal control over financial reporting, with respect to fiscal years ending on or after November 15, 2004. For other engagements conducted pursuant to the standards of the PCAOB, including reviews of interim financial information, this standard takes effect beginning with the first quarter ending after the first financial statement audit covered by this standard.

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form of paper, electronic, or other media) that are created, sent, or received in connection with an engagement conducted in accordance with auditing and related professional practice standards and that contain conclusions, opinions, analyses, or data related to the engagement. (*Retention of Audit and Review Records*, 17 CFR §210.2-06, effective for audits or reviews completed on or after October 31, 2003.)